

Insights

Cyprus Substance Requirements

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Introduction

The purpose of this memo is to consider and detail the requirements of substance in Cyprus. The requirement to show “substance” in Cyprus or indeed any EU Member State or any other low tax jurisdiction is not something new and thus is not (as many claim) the new buzz word or an evolving concept. The requirement for substance has been discussed and considered for some time in the context of determining effective management and control and was also considered in the *Cadbury Schweppes case*¹ and subsequent cases which have all concluded to the effect that the motives for putting in place structures in order to achieve tax efficiencies must not be “wholly artificial arrangements” and there must be some “genuine economic activities”.

The concept of substance is (and has been) inherent in determining effective management and control of legal entities, which is at the centre of determining tax residency for domestic tax legislation and also for the purposes of double tax treaties. Furthermore, as we shall see below it is also a factor in determining “beneficial ownership”, which is a defining criteria with regard to payments (dividends, interest, royalties etc.) and their treatment under double tax treaties.

Substance

Following on the work done by the OECD under Action 5 of the Base Erosion and Profit Shifting (BEPS) project, the European Union (EU) Code of Conduct Group (COCG) conducted an investigation into certain low or no corporate income tax regimes which has resulted in such jurisdictions being required to put in place laws to address economic substance matters by the end of 2018 to avoid being placed back on an EU Blacklist of non-cooperative jurisdictions. The introduction of these rules adds another facet to consider in establishing substance and should be considered alongside other tax substance requirements in the OECD/EU as well as local regulatory requirements.

As a consequence many of such affected jurisdictions (including the Bahamas, Bermuda, the British Virgin Islands, the Cayman Islands, Guernsey, the Isle of Man and Jersey) responded to the EU’s mandate by enacting economic substantive legislation with effect from 1 January 2019, which defines what are substance requirements. This was done purely and simply to prevent these jurisdictions from being placed on the EU’s black or grey lists.

An examination of the legislative provisions of each of these jurisdictions, which we suggest is not a benchmark for Cyprus (or any other EU jurisdiction) in determining what constitutes the required level of substance, provides that substance is constituted and determined by:

- the company being directed and managed in the relevant jurisdiction;

¹ C-196/04 Cadbury Schweppes plc & Anor V Commissioners of Inland Revenue

- adequate number of qualified employees;²
- adequate expenditure proportionate to the level of activity;
- adequate physical presence;
- conduct of core income generating activity.

All these requirements have, of course to be analysed in the context of the conduct of business in the relevant sectors³ as identified by the COCG which includes activities as a holding company which they have clearly determined require a lesser substance requirement due to the nature of activity and income generated. In simple terms, a holding company, due to the nature of its operation requires lesser substance than a trading company in order to determine residency.

Management and Control – Substance

Much has been written to suggest these are distinct issues but in fact they are and always have been one and the same test. The starting point from a tax planning viewpoint is always to determine residency which under Cyprus Income Tax Law is defined for the purposes of a company as being the place where effective management and control is exercised. This is also the test set out in most if not all DTTs to which Cyprus has signed up. The test of corporate residency and effective management and control is a matter that has been judicially pronounced upon on many occasions and is now trite law. The simply stated is that a company is resident “where the central management and control actually abides”.⁴ This has been judicially accepted as a question of fact. In practice in the context of a Cyprus structure (holding or otherwise) what that means is that:

- all or a majority of directors are resident of Cyprus;
- decisions are not only taken but seen to be taken in Cyprus;
- all decisions are implemented in Cyprus – in other words all actions consequent upon the decisions are done in Cyprus, for e.g. signing agreements etc;
- regular board meetings are held in Cyprus at which decisions are taken and implemented – the number of board meetings should not be less than 3 per year (perhaps more if the activity of the company merits it) and during which any foreign resident director should attend in person.

² This does not mean that they are actually employees of the company but they are seconded to or devote sufficient time to the business of the company

³ Banking, insurance, shipping, fund management (this does not include companies that are Collective Investment Vehicles), financing and leasing, headquartering, operation of a holding company, holding intellectual property (IP), distribution and service centres.

⁴ De Beers Consolidated Mines (1903-1911) 5 TC 198

These are all indicia of Cyprus effective management and control and have been as a matter of law the requirements for such a determination.

Substance is not a different or separate test to effective management and control but rather is a subset of that test and *de jure and de facto* should not arrive at a different conclusion. The contents and benchmark for substance are in effect the same as those for effective management and control and thus underpin:

- tax residency;
- residency for DTT purposes; and
- beneficial ownership requirements.

The substance requirements that are the current discussion in much of tax planning⁵ structures or otherwise are in our view not greater than what is considered the normal test for effective management and control.

Substance and Beneficial Ownership

In the context of the requirements discussed above we would advise in order to satisfy residency and substance requirements in Cyprus the following elements should be present:

- all or a majority of the directors are Cypriot resident;
- the directors have the necessary qualifications and experience that allow them to understand and take effective decisions regarding the business of the Company⁶;
- all board of directors meetings are held in Cyprus;
- all directors, including any overseas directors attend board meetings in Cyprus;
- all decisions are taken and implemented in Cyprus, meaning all agreements etc., are signed in Cyprus;
- full and complete record keeping in Cyprus.

The above in addition to the statutory obligations of maintaining books and records, accounts, relevant registers should further add to the satisfaction of substance. However, each case will

⁵ One should avoid all the talk of equating tax planning with any suggestion of tax avoidance or tax evasion, tax planning is always seen as a means to efficiently and effectively structure holdings. However the use of Cyprus entities may and frequently is for reasons other than tax planning.

⁶ The directors cannot be simply nominee directors, they need to be people of standing and experience

turn on its facts and particularly a holding company will require satisfaction of a lesser test of substance than a trading or operating or financial services or investment company.

This memo serves as a guide only to the provisions of the DTT and should not be considered legal or tax advice. For specific legal and tax advice please contact us as per the below.

9 August, 2019.

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